NEWS RELEASE

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TREASURER ANGELIDES WARNS OF NEARLY $10 BILLION BUDGET GAP IN 2005-06 IF GOVERNOR SCHWARZENEGGER, LEGISLATURE DO NOT TAKE IMMEDIATE ACTION TO END UNTAMED DEFICIT SPENDING

California 'Right Back Where We Started From,' Angelides Says, Facing Same Massive Deficit In 05-06 As When Governor Took Office

SACRAMENTO, CA – California Treasurer Phil Angelides warned today that the state budget gap could approach $10 billion in the next year – a hole the same size as when Governor Schwarzenegger took office last November – unless the Governor and Legislature take immediate action to address the State's ongoing, and growing, budget imbalance.

Of more immediate concern, Angelides said – with the Governor's May budget revision expected later this week – is that the Schwarzenegger Administration's spending plan for the 2004-05 fiscal year, presented in January as a balanced budget, now faces a hole of up to $3.3 billion, despite higher-than-forecast revenues.

"California is 'right back where we started from,'" Angelides said at a morning news conference, "because the Governor's original spending plan already relied heavily on borrowing, deferrals and one-time measures to reach nominal balance. Our budget gap has widened because the Governor proposed a series of 'corrective' actions that were never actually taken; made rosy assumptions that never materialized; failed to plan for costly, adverse court decisions; and counted on state and federal revenue solutions that have not and may never be realized."

"There is no more time for delay, no more time – or money – to borrow ourselves out of our problems," Angelides said. "Later this week in his May budget revision, the Governor must offer a responsible, fair and structurally sound blueprint for balancing the State's budget now and for the future."

Because of the State's repeated failure to address the structural imbalance of revenues and expenditures, the Treasurer said California could have a hole of up to $3.3 billion in the upcoming 2004-05 budget year, if the Governor's January budget proposal is enacted; a wider, nearly $10 billion budget gap – or, about $27 million a day in deficit spending – in the following, 2005-06 year; and a new load of "inherited debt" weighing down its future.

Angelides pointed out that the nation's major credit rating agencies share his concerns. Standard & Poor's, for example, reported earlier this year, "The State's increased ability to sell bonds to fund current operations merely postpones difficult taxation or expenditure reduction decisions. Similar liquidity pressures may again arise absent true reform, which would bring ongoing revenues and expenditures into balance. The State's structural deficit has not appreciably improved compared with the same period last year, despite economic improvement."

The State already faces a $7 billion shortfall for the 2005-06 budget year, which begins July 1, 2005, even if the Legislature were to adopt all of the Governor's proposals, according to the nonpartisan Legislative Analyst's Office (LAO). But that gap could grow to nearly $10 billion if these new holes in the budget are not filled – the same deficit that the LAO said Schwarzenegger faced when he took office last November.

The Governor's own budget released in January identified a $14 billion shortfall for the 2004-05 fiscal year, and his Administration offered a nominally balanced budget to close that gap. But as he approaches his May budget revision later this week, the true imbalance of the Governor's budget has come to light for a variety of very costly reasons.

For example, the Governor in January proposed $2 billion in spending cuts, loans, fund shifts and transfers in the current and prior years. But the Legislature has approved only $990 million of that total, adding the more than $1 billion remainder to the 2004-05 budget gap. And the LAO has estimated that the Schwarzenegger Administration has underestimated by $400 million state spending for the current and upcoming fiscal years on ongoing state programs.

In addition, four significant court decisions have gone against the State since January, costing the General Fund nearly $2 billion in higher spending and lost revenue that previously had been counted upon to pay other state expenses.

The Governor's budget also included nearly $2 billion in solutions that have not and may never be realized, including: a $929 million pension obligation bond, a similar of version of which has been blocked by the courts; $500 million in Indian gaming revenues; and $350 million in various kinds of federal aid.

To counter some of that red ink, Angelides said, year-to-date revenues, swollen by an amnesty program for participants in abusive tax shelters, have come in nearly $1.8 billion higher than expected.

Even so, the Treasurer said the California's economy will not be able to grow the State out of the deficit in which it now sits. Closing the State's projected budget gap through higher economic growth alone would require that the unprecedented stock bubble of the late 1990s be repeated and sustained for years, an unlikely event.

"When you add up the numbers, it becomes crystal clear: California must restore fiscal responsibility, promote budgetary fairness and expand opportunity for all Californians by seeking a fair balance between spending cuts and restoring revenue lost through now unjustified tax cuts to corporations and the wealthiest Californians," Angelides said.

“It is wrong for the Governor’s budget to propose damaging cuts to higher education, transportation and children's health programs – investments that are vital to the future prosperity of our State's economy – without even attempting to close one corporate tax loophole,” Angelides added, “or restore the upper-income tax rates on the wealthiest Californians that were in place during the Governor Ronald Reagan and Pete Wilson years.”

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California… Right Back Where We Started From

Governor's January Budget Up To $3.3 Billion in Hole.
Immediate Action Needed to End Continuing Deficit Spending

Summary

In January, the Governor presented a 2004-05 budget that, by law, is supposed to be balanced. Despite higher than forecast revenues in the current year, a hole of up to $3.3 billion has opened in his original proposal, a plan that already relied heavily on borrowing, deferrals and one-time measures to reach nominal balance. Without immediate action by the Governor in the May Revision to address the State's ongoing and growing budget imbalance, California will have more deficit spending in 2004-05, a wider budget gap in the 2005-06 year, and a new load of "inherited debt" weighing down its future. The State already faces a $7 billion shortfall for 2005-06, according to the nonpartisan Legislative Analyst's Office (LAO), even if the Legislature adopts all the Governor's proposals. The 2005-06 budget gap could approach $10 billion if the new holes in the budget are not closed with real budget-balancing solutions, leaving California with a budget problem of the same size—about $27 million a day in deficit spending—as when the Governor took office last November.

The Unbalanced Budget

The Governor's January budget identified a $14 billion shortfall for the 2004-05 fiscal year and proposed solutions to close the gap. But in the intervening months, the Governor's budget has fallen out of balance for a variety of reasons (see Attachment A for a more complete listing):

- Some assumed budget actions were not taken. The Governor proposed about $2 billion of mid-year spending cuts, loans, fund shifts and transfers in the current and prior years. The Legislature approved $990 million, adding the remainder to the 2004-05 budget gap.

- The LAO has challenged some of the Governor's budget assumptions. For example, the LAO projects that the Governor's budget underestimated spending in the current and budget year by a combined $400 million.

- Some court decisions have gone against the State, adding new costs or reducing revenue. For example, the California Supreme Court let stand a lower court ruling against the State in the Farmer Bros. Co. tax case, a decision that will require the State to make an estimated $500 million to $1.5 billion in tax refunds to corporations. In another example, the courts found the State liable for damages caused by the failure of levees in the 1986 floods.

- Some budget solutions offered by the Governor have not materialized, and may never come to pass. He proposed, for example, a $929 million pension obligation bond. But a Superior Court has blocked a similar pension obligation bond approved a year ago for the current budget year. The budget assumed $350 million in federal assistance not budgeted by President Bush. The budget also projected that the State would negotiate at least $500 million annually in revenue from Indian gaming tribes. This money has not yet arrived. Newspaper accounts of the negotiations suggest that the Governor is seeking to have tribes pledge an annual amount to the State (of far less than $500 million), then borrow against that cash stream to give the State an upfront infusion in the budget year. If those reports are accurate, such a deal would convert the budget's assumption of a continuing stream of gaming revenue into a one-shot gain.

Some of the deterioration has been offset by revenue gains. The combination of a strong 2003 stock market, an improved economy, and a tax amnesty adopted last year by the Legislature and then-Gov. Davis has brought in $1.8 billion more revenue in the current year than projected in the budget.

An Untamed Deficit

To deal with these budget setbacks, the Governor in the May Revision must either come up with real budget-balancing solutions—which end the State's continuing deficit spending—or resort to more gimmicks and borrowing. The Governor has already proposed substantial borrowing and one-time fixes in his January budget, including the use of $3 billion of the Economic Recovery Bonds approved by the voters on March 2 to cover deficit spending next year. Using more of the bond proceeds to plug the emerging holes in the budget would increase California's future debt load and do nothing to tame the State's deficit.

As Standard & Poor's noted in a statement released March 3, "The State's increased ability to sell bonds to fund current operations merely postpones difficult taxation or expenditure reduction decisions. Similar liquidity pressures may again arise absent true reform, which would bring ongoing revenues and expenditures into balance. The State's structural deficit has not appreciably improved compared with the same period last year, despite economic improvement."

California cannot assume that a growing economy will, by itself, end the State's fiscal crisis. The proposed budget already assumes strong economic growth in the budget year and reflects the buoyant stock market of 2003, when the share prices of some major California high-tech firms doubled. Closing the State's projected budget gap through higher economic growth alone would require that the unprecedented stock bubble of the late 1990s be repeated and sustained for years, an unlikely event.

The LAO estimated that even if all of the Governor's January proposals were to be adopted, California would still have a $7 billion gap between spending and revenue in the 2005-06 budget. The deficit persists because the Governor's budget relies upon $8 billion of borrowing, deferrals and one-time measures, rather than permanent solutions. If the up-to-$3.3 billion hole in the Governor's budget is pushed into the future with one-time measures and more borrowing, the 2005-06 budget discussions would start with a $10 billion gap—$27 million a day, the same size as when the Governor took office.

As Standard & Poor's has rightly noted, "Due to the magnitude of the structural deficit in fiscal 2005 and the risks to fiscal 2004, the window to make structural budget changes will not last very long."

Creating New Inherited Debt

Beyond the difficulties the Governor's budget leaves for the 2005-06 budget year, his spending plan—as well as some of the Governor's subsequent reported deals with interest groups—create an even more troubling pattern of passing today's problems into the future. In education, for example, the Governor's proposal to fund Proposition 98 below the minimum guarantee for last year and the current year creates an obligation to begin "settling up" the $966 million savings in 2006-07. All told, the budget raises the balance on the State's "education credit card" of deferrals and unfunded mandates to $3.8 billion, according to the LAO—with no revenues identified to pay the bill. In return for local government consent to his taking of $1.3 billion in property taxes for the next two years, the Governor is reported to be proposing to return and guarantee local revenues after that and start repaying about $1 billion of unpaid state mandates, creating a new gap for future budgets.

"No more deficit financing," the Governor said earlier this year. But deal by deal, deferral by deferral, he is amassing new "inherited debt" that goes beyond the 10 to 15 years of debt-service payments on the Economic Recovery Bonds.

California… Right Back Where We Started From

Governor's January Budget Up To $3.3 Billion in Hole.
Immediate Action Needed to End Continuing Deficit Spending

Estimated Amount (in millions of dollars)	New holes and plugs in the budget
	Actions not taken
-$1,049	**Prior years solutions unrealized**: The Governor proposed about $2 billion in mid-year non-Proposition 98 spending reductions, fund shifts, transfers and loans for fiscal year 2002-03 and the current 2003-04 year. The Legislature approved $990 million of these changes, adding to the budget-year gap.
	Rosy assumptions
-$400	**Spending above budget forecast**: The nonpartisan Legislative Analyst's Office (LAO) estimated that spending for the current and budget years for ongoing programs will be higher than the budget forecasts.
	Adverse court decisions
-$650	**Farmer Bros. Co. decision**: In February, after the release of the budget, the State lost a court case concerning taxation of certain dividends received by corporate taxpayers. The decision makes the State liable for tax refunds estimated at $500 million to $1.5 billion by the LAO.
-$200	**CalWORKS grants and the Vehicle License Fee**: The 1998 law reducing the VLF required the State to grant cost-of-living increases for CalWORKS recipients in any year that it had enough revenue to reduce the fee on car owners. A Superior Court ruled in March that the Governor's November rollback of the VLF requires the State to grant the COLA at a cost of about $10 million a month.
-$736	**Medi-Cal provider rate reduction**: The budget assumes savings from a further 10 percent reduction in Medi-Cal provider rates both for the current and budget year. But the previous 5 percent rate reduction scheduled to go into effect in January has been blocked by a federal district court, and no rate reduction has occurred.
-$300	**Flood claims**: The California Supreme Court in March refused to hear an appeal of lower court decisions making the State liable for damages caused by 1986 flooding from a break in a state levee on the Yuba River. Claims are expected to be in the "hundreds of millions" of dollars.

	Unrealized solutions
-$350	**Assumption of federal aid**: The budget assumes California will receive $350 million in various kinds of federal aid. The money has not been budgeted by the Bush administration or appropriated by Congress. This aid is uncertain at best at a time of record federal budget deficits.
-$183	**IHSS waiver**: Last month, the administration withdrew its budget proposal to eliminate state-only Residual In-Home Supportive Services. It is seeking a federal waiver to cover half the state cost.
-$500	**Indian gaming revenues**: The budget assumed that the State would sign agreements with Indian gaming tribes granting revenue from their operations. The administration is negotiating with tribes but no agreements have yet been announced. News accounts report tribes may bond against future pledges of revenue to provide the State with a one-time payment.
-$929	**Pension obligation bonds**: The Governor proposes to defer state payments to employee pension funds by issuing pension bonds. But a Superior Court has blocked a similar pension obligation bond for the current year. A state appeal is pending.
	Revenue gain
+$1,766	**Higher revenue than budgeted:** April income tax payments from 2003 stock market gains and an amnesty for participants in abusive tax shelters came in higher than projected, offsetting a previous year-to-date shortfall in revenues.
-$3,255	**Total**

California…
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STATE BUDGET GAP REMAINS